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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1967

No. 871

EARL R. WISEMAN, DIRECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF OKLAHOMA,
Petitioner,

vs.

RALPH E. BARBY AND MARIE BARBY,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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BRIEF FOR RALPH E. BARBY AND MARIE BARBY, IN OPPOSITION

OPINION BELOW

The opinion of the Court of Appeals (Pet. App. 1-17) is reported at 380 F.2d 121.

JURISDICTION

The judgment of the Court of Appeals was entered on July 5, 1967. (App. 17). By order dated September 29, 1967, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including December 2, 1967. Mr. John F. Davis, Clerk, extended the time for filing a brief in Opposition to said petition to February 21, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

The question as presented by Petitioner "is whether the $300,000.00 received for the assignment of the production payment was capital gain, as the Court below held, or ordinary income subject to the depletion allowance, as petitioner contends."

More precisely stated, four questions demand attention:

1. Did said production payment so reserved by respondents constitute a "mineral property", separate and independent of the traditional one-eighth royalty interest similarly reserved by them?

2. If said production payment did constitute a separate mineral property reserved by respondents, did it also constitute a capital asset in their hands?

3. If said production payment constituted a separate mineral property, and, in respondents' hands, a capital asset, did the two separate sales of undivided half interests therein result in long-term capital gain to respondents?

4. Does the ruling below conflict with a decision of this Court (*Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260),

or decisions of the Court of Appeals for the Fifth Circuit (*United States* v. *Foster*, 324 F.2d 702, and *Floyd* v. *Commissioner*, 309 F.2d 95), as asserted by petitioner?

STATUTES INVOLVED

Internal Revenue Code of 1954:

Sec. 614: DEFINITION OF PROPERTY.

"(a) *General Rule.*—For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

"(b) SPECIAL RULES AS TO OPERATING MINERAL INTERESTS IN OIL AND GAS WELLS.—In the case of oil and gas wells—

"(1) IN GENERAL.—Except as otherwise provided in this subsection—

"(A) All of the taxpayer's operating mineral interests in a separate tract or parcel of land shall be combined and treated as one property, and

"(B) the taxpayer may not combine an operating mineral interest in one tract or parcel of land with an operating mineral interest in another tract or parcel of land."

* * *

Sec. 1221. CAPITAL ASSET DEFINED.

"For purpose of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

"(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;"

* * *

Sec. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

* * *

"(3) LONG-TERM CAPITAL GAIN—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income."

* * *

(26 U.S.C. 1964 ed., Sec. 1221, 1222, 614.)

STATEMENT

Respondents had, for many years, owned land from which there was no oil and gas production, though recently deemed by them and Cabot Carbon Company to be potentially productive. On November 5, 1956, respondents leased this land to Cabot, reserving, in addition to the usual one-eighth (1/8) perpetual royalty interest, "as a separate and distinct property interest, an undivided ninety percent (90%) of seven-eighths (7/8) of all oil, gas and other hydrocarbons in and under and that may be produced, and saved from * * *" said lands "until from the proceeds of the oil, gas and other hydrocarbons ac-

cruing to the Production Payment Interest, if, as and when produced, saved, and sold, lessors, their heirs, successors and assigns shall have received the aggregate of (1) the full net sum of $300,000.00 in cash, plus (2) an amount equal to interest at the rate of 5 1/2% per annum on the unliquidated balance * * *." If, as and when such total sum had been received, said Production Payment Interest terminated. (R. 27). In addition, respondents, with other joint land owners, received a cash lease bonus of $25,000.00, which they returned as ordinary income. (R. 109, Par. 20).

On the same day said lease was made, respondents conveyed an undivided one-half (1/2) of said Production Payment Interest in an arms length transaction (R. 109, Par. 19), to Eby, Inc., for a cash consideration of $150,000.00. (R. 39-44).

On January 3, 1957, respondents conveyed the remaining undivided one-half (1/2) of said Production Payment Interest, in another arms length transaction (R. 109, Par. 19), to Tokay Oil Company for a cash consideration of $150,000.00. (R. 45-49). Respondents reported each of said conveyances as the sale of a capital asset; reported a capital gain thereon; and paid their income tax applicable thereto. (R. 24). Petitioner determined said gains to be taxable as ordinary income and asserted tax deficiencies (R. 3) which were subsequently paid by respondents, who then filed timely claims for refund; and upon denial thereof by Petitioner, timely filed a suit for refund. (R. 1-2). Petitioner admits there was no collusion between the taxpayer, the lessee and the purchasers of said Production Payment Interest and that there was no scheme to conceal a large bonus. (R. 109-110, Par. 23).

The District Court ruled that respondents reserved two separate mineral interests from the lease conveyed to Cabot Carbon Company, both constituting royalty interests:

(1) One in perpetuity (the traditional landowners royalty); and

(2) One limited in duration (the Production Payment Interest);

that each such mineral interest was neither dependent upon, nor in any sense qualified, limited or affected by the other mineral interest; that the sale of the Production Payment Interest, in undivided halves, constituted the sale of a capital asset; and that the gain from said sale constituted a long-term capital gain. (R. 110, Pars. 1, 2, 3, 4).

The Court of Appeals affirmed, distinguishing the case, on its facts, from *Commissioner* v. *P. G. Lake, Inc., supra; U. S.* v. *Foster, supra; Floyd* v. *Commissioner, supra;* and *Estate of Killam*, 33 T.C. 345. (Petitioner's Appendix, 11-15).

ARGUMENT

1. Did respondents' reserved production payment constitute a mineral interest separate and apart from their reserved, traditional one-eighth (1/8) perpetual royalty interest of a landowner?

No question has been raised concerning respondents' ownership of the retained one-eighth (1/8) royalty interest constituting an interest in minerals. Such status is therefore conceded.

We pass then to the question: Did respondents' reservation, also, of "an undivided ninety percent (90%)

of 7/8 of all oil, gas and other hydrocarbons" of a value of $300,000.00, similarly constitute a separate and distinct interest in the minerals?

That such a reserved production payment does constitute such an interest in minerals is universally attested by numerous decisions of this Court; by many lower federal courts; by the legislative history leading up to and culminating in the definition of a mineral property in Section 614 (a) of the Internal Revenue Code, *supra;* and by formal regulations, rulings and memoranda of the United States Treasury Department.

In the opening paragraphs of *Commissioner* v. *P. G. Lake, Inc., supra,* Justice Douglas, speaking for this Court, stated:

> "The Court of Appeals started from the premise * * * that oil payments are interests in land. We, too, proceed upon that premise." (Page 264).

This Court, in *Anderson* v. *Helvering,* 310 U.S. 404, in distinguishing the status of the taxpayer there, who held adequate security for the payment of the balance of the sales price over and above that of a holder of a simple oil payment right with its characteristics, stated with reference to the value of the latter:

> "* * * yet it (the oil payment right) does depend upon the production of oil * * *. Accordingly, this Court in Thomas v. Perkins (301 U.S. 655) decided that the provision in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, and should be given the same tax consequences as a provision for oil royalties. The decision did not turn upon the particular instrument involved, or upon the formalities

of the conveyancer's art, but rested upon the practical consequences of the provision for payment of that type." (Page 410).

In *Palmer* v. *Bender*, 287 U.S. 551, this Court, in delineating the respective rights to oil of both the lessor (who had reserved an oil payment of $1,000,000.00 from the lease) and the lessee, stated with reference to the rights of the reserving lessor:

> "It is enough, if by virtue of the leasing transaction, he has retained a right to share in the oil produced If so, he has an economic interest in the oil, in place * * *." (p. 557).

Lower federal courts, including the Court of Appeals for the Fifth Circuit, universally follow the above outlined reasoning of the Court in recognizing the interest of a lessor, who has reserved an oil or gas payment, as the owner of a mineral property:

Caldwell v. *Campbell*, 5 Cir., 218 F.2d 567;

T. L. Lee v. *Commissioner*, 5 Cir., 126 F.2d 825;

Ortiz Oil Co. v. *Commissioner*, 5 Cir., 102 F.2d 508;

Fleming v. *Commissioner*, 5 Cir., 82 F.2d 324;

Williams v. *Commissioner*, 5 Cir., 82 F.2d 328;

Holly Development Co. v. *Commissioner*, 9 Cir., 93 F.2d 146.

The United States Treasury Department has, for over a half century similarly recognized a production payment right (which is solely dependent upon production of oil and gas), as an interest in a mineral property, separate and apart from any other type of interest he may own in such property.

As a matter of historical fact, the United States Treasury Department has consistently ruled that if a taxpayer owns more than one interest,

> "in the same tract or parcel, each interest is a 'property' within the comprehension of that term as used in the provisions of the Revenue Acts fixing a basis for the computation of depletion. As the basis fixed also governs the computation of gain or loss, it follows that a depletable 'property' is also an asset subject to sale or other disposition giving rise to gain or loss. Accordingly, each such interest must be treated as a separate 'property' for income tax purposes. Failure to treat each such separate interest as a separate property would disregard or unduly confuse the administration of the provisions of the Revenue Acts requiring the computation of gain or loss upon the sale of an asset and the provisions distinguishing between ordinary income and capital gain or loss taxable at different rates * * *." G.C.M. 22106, C.B. 1941-1, 245-250, at page 246.

Substantially the same provisions are found in the following:

G.C.M. 22730, C.B. 1941-1, p. 214;

G.C.M. 24094, C.B. 1944, pp. 250-255;

G.C.M. 24849, C.B. 1946-1, p. 66;

Treasury Regulations 74, Article 221 (1929);

Treasury Regulations 77, Article 221 (j);

Treasury Regulations 86, Article 23 (m)-1 (j), (1934).

Finally, the Congress codified such Treasury construction into a statutory definition of interests owned in a mineral property in Section 614, Internal Revenue Code of 1954 (26 U.S.C., 1964 ed., Sec. 614), *supra*. To clarify its meaning of terms used in said Section, the Senate Finance Committee made the following statement:

"This section corresponds to section 614 of the bill as passed by the House, and has no counterpart in the 1939 Code. It provides a statutory definition of the term 'property' for purposes of computing the depletion allowance in the case of mines, wells, and other natural deposits. Present law contemplates that the depletion allowance shall be computed by properties, but provides no definition of 'property'.

"Section 614 (a) is identical with the corresponding provision as passed by the House. It provides a general rule which states that for the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. For purposes of this definition tracts or parcels may be separated by conveyancing as well as geographically."

(Senate Report No. 1622, 83rd Congress, 2d Session 333 (1954).

Continuing, said report provided:

"Your committee has amended section 614 (b) (1) to provide that an aggregation adopted under this section shall be effective for all purposes of the income tax subtitle, and is not limited to the computation of percentage depletion, as under the House bill. The effect of this amendment is to make the definition of property consistent so as to be applicable to the computation of both cost and percentage depletion, and to the computation of gain or loss upon a sale or exchange."

Treasury Regulations, paragraph 1.614-1, issued under said Section 614 of the Internal Revenue Code of 1954, provided in applicable part, as follows:

"(a) General rule.—(1) For purposes of subtitle A of the Code, in the case of mines, wells and other natural deposits, the term 'property' means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

"(2) The term 'interest' means an economic interest in a mineral deposit. See paragraph (b) of Sec. 1.611-1. The term includes working or operating interests, royalties, overriding royalties, production payments and net profits interests."

Said Regulation continues and provides, in applicable part, as follows:

"(b) Separation of interests treated as 'single property' under prior regulations. * * * Each separate mineral interest which, in accordance with paragraph (a) of this section, is separate property shall be so treated, notwithstanding the fact that the taxpayer under paragraph (i) of Sec. 39.23 (m)-1 of this chapter (Regulations 118) and corresponding provisions of prior regulations may have treated more than one of such interests as a 'single property'."

This same statement appears today in the current Treasury Regulations as the same Section No. 1.614-1 (b).

From the foregoing history of Regulations, Rulings, Interpretations, and finally, statutory construction represented by Section 614 of the Internal Revenue Code of 1954, which is still the law today, it is abundantly clear that the Treasury Department and the Congress have considered the term "property" to mean and include each separate interest (including oil payments) owned by the taxpayer in each mineral deposit in each separate tract of land.

Furthermore, it is clear that the Senate Finance Committee, in its aforementioned Report on Section 614 of the

Internal Revenue Code of 1954, recognized that such interests may be "separated by conveyancing as well as geographically". (Senate Report No. 1622, *supra*).

In the instant case, the agreed facts are that taxpayers, then owners in fee of the land involved, reserved two separate mineral interests therein, when they executed the subject lease to Cabot Carbon Co., Inc. (Joint Ex. A, Sec. 3 and 4, R. 25-27):

1. The usual 1/8 royalty interest of a fee owner, and
2. An undivided 90% of 7/8 of all oil, gas and other hydrocarbons in and under said leased lands, until an amount equivalent in value to $300,000.00 plus an interest factor, was recovered.

Appellant is in the anomalous position of here maintaining that the retained oil payment is not a mineral property, when the Government has consistently, for a period of more than a half century, steadfastly maintained just the opposite, i.e., not only for depletion purposes, but for the purposes of determining gain or loss upon the sale of mineral interests:

> "if a taxpayer holds several interests in the same tract or parcel, each interest is a 'property' within the comprehension of that term as used in the provisions of the Revenue Acts fixing a basis for the computation of depletion. As the basis fixed also governs the computation of gain or loss, it follows that a depletable 'property' is also an asset subject to sale or other disposition giving rise to gain or loss." (G.C.M. 22106, C.B. 1941-1, pp. 245-250.)

The Tax Court has recognized the principles herein advanced by Respondents, and in a 1946 opinion, *Herndon Drilling Co.*, 6 T.C. 628 (1946), clearly stated the law ap-

plicable to the instant case. There, the taxpayer had acquired both an undivided one-half (½) interest in:

1. the working interest and
2. an oil payment payable with six percent (6%) interest out of the other one-half (½) of the working interest.

The oil payment was to terminate at such time as taxpayer had recovered an amount equal to certain expenditures previously made by taxpayer. In such case, taxpayer was attempting to combine both mineral properties as one. The Goverment, however, contended that said interests were separate; directly contrary to its contentions in the instant case.

In holding that taxpayer's two interests in the mineral property each constituted "a separate capital asset", the Court set forth principles we believe most persuasive in the case at bar, when it stated:

> "We think that under the facts here, the two interests in each lease must be held to be two properties, and we so hold. They are inherently separate and different in character. One is an outright ownership in fee of an undivided part of its leasehold estate. The other, is less than a fee title interest in the remaining undivided part of the leasehold. There is no merger of the titles to the two interests. See GCM 24094, 1944 CB 250, CF Wm. H. Cree, 47 BTA 868."

Continuing, the Court stated:

> "Not only was it realistic and practical for petitioner to treat the two interests as separate properties, as was done in Black Mountain Corporation, 5 TC 1117, but it was under a legal obligation to so treat them in recording expenditures and income."

As the foregoing history leading up to the enactment of Section 614 of the Internal Revenue Code of 1954 discloses, the framework of the law as it existed at the time of Herndon was not materially different than the principles codified by the passage of said Section 614.

It is therefore respectfully submitted that the Herndon principles, augmented by the legislative history set forth above, control the present controversy. Here, as there, the taxpayers retained two distinct "interests"—one an "outright ownership in fee" of a royalty interest, the other something less than a "fee title interest". There could be no merger of titles for the one interest continues for the duration of production, while the other may terminate long in advance of the cessation of production. Here, also, as there, the production attributed to each of the separate interests would require separate accounting for the one terminates after an amount of production equalling a specified dollar amount has been allocated to such separate interest. Only by treating the interests separately can the termination point of the one interest be determined.

Although GCM 24849, 1946-1 C.B. 66, I.T. 3895, 1948-1 CB 39, and I.T. 4003, 1950-1 C.B. 10, were issued in the years 1946, 1948 and 1950, respectively, there had been no judicial sanctions of such attempted changes in policy of the Treasury Department prior to the passage of the Internal Revenue Act of 1954, effective as of August 16, 1954. (Title 26, U.S.C. 614, *supra*).

That an oil payment is a mineral "property" has not only been established by a half century of administrative practice and treatment by the Government itself as above outlined, but also by Federal Courts in their recognition of a production payment interest as constituting an "economic interest", and as an interest in oil and gas, in place, in numerous cases.

II. Did said production payment interest constitute a capital asset in the hands of respondents?

We address this section to the simple proposition, namely, that such reserved oil payment constituted a capital asset within the intent of the Federal Internal Revenue Code.

Because this is a fundamental question, we deem it advisable to trace the history of the capital asset provisions of the Internal Revenue Code from their inception in the Internal Revenue Code of 1921; therefore, a concise history of said capital asset provision from the 1921 Internal Revenue Code to what now appears as Section 1221, 26 U.S.C., 1964 ed., Section 1221, follows:

Section 206 (a) of the 1921 Internal Revenue Code read as follows:

> "(6) The term 'capital assets' as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock or shares in a corporation, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."

The purpose and coverage of said definition was succinctly summarized by the House Ways and Means Committee Report (67th Cong., 1st Sess. H. Rept. 350), which reads, in applicable part, as follows:

> "Section 206. The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump

sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section * * * to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subjected to an income tax in excess of 15 percent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 percent is also applied to capital losses. Under present conditions there are likely to be more losses than gains."

Such purpose was likewise evidenced by the U. S. Senate as reflected by the Senate Finance Committee in its Report (67th Cong., 1st Sess. Rept. 275), which in applicable part, reads as follows:

"Section 206 limits the rate of taxation upon gain derived from the sale of capital assets. Under the present law many sales of farms, mineral properties, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum and the amount of surtax excessively enhanced thereby. In order to permit such transactions to take place without fear of prohibitive tax, section 206 provides that only 40 percent of the net gain derived from the sale or other disposition of capital assets will be taken into account in determining the net income upon which the income tax is imposed. This automatically reduces the rate of taxes applicable to such income by 60 percent."

The concept of the term "capital assets" as above defined in the 1921 Revenue Act, has been continued basically through successive Revenue Acts into the Internal Revenue Code as it exists today, refined only in the following aspects:

1. Whereas the 1921 Act definition covered property acquired and held by the taxpayer for profit and investment, Section 1221 of the present Internal Revenue Code covers simply "property held by the taxpayer."

2. The exceptions contained in the 1921 Act have been increased to exclude:

a. Copyrights, literary and music or artistic compositions, etc., (Sec. 1221 (3).)

b. Accounts and notes receivable acquired in the order or course of trade or business (Sec. 1221 (4).)

c. Obligations of the U.S., etc., issued on a discount basis. (Sec. 1221 (5).)

None of said additional exceptions are applicable in the present case.

3. An analysis of the essence of the statutory definition of capital assets shows, as it now appears, that capital assets include all property held by the taxpayer (whether or not connected with his trade or business) except:

a. Stock in trade (or inventory) or property held by the taxpayer primarily for sale in the ordinary course of taxpayer's trade or business;

b. Property used in the trade or business subject to depreciation or real property not used in his trade or business;

c. Copyrights;

d. Accounts and notes receivable acquired during the ordinary course of business;

e. Obligations of the U.S. or political subdivisions issued at a discount, and payable without any interest.

Further evidence of the Congressional intent is shown by the Report of the Senate Committee on Finance, Sen. Rept. 1631, which accompanied H.R. 7378, with respect to reducing the holding period of capital assets from twenty-four to six months in the determination of capital gains and losses, wherein said Committee felt that lowering of the holding period would have the effect of encouraging realization of capital gains and would therefore result in added revenue. Furthermore, that Committee felt that a six months holding period was a sufficient deterrent to speculators who might otherwise profit by the shorter holding period. 77 Cong., 2nd Sess. (1942), Sen. Rept. 1631.

It is therefore abundantly clear that the oil payment reserved by respondents in this case does not appear as one of the exceptions within the definition of the term; and therefore, it must be classed as a capital asset unless the plain provisions of the statutes are ignored and the Courts substitute their own definition of a capital asset.

An excellent treatment of this particular problem appears in 69 Harvard Law Review 985-1019, in an article by Mr. Stanley S. Surrey, then Professor of Law, Harvard Law School, and presently serving as Assistant Secretary of the United States Treasury. In contrasting the problem faced by Congress in taxing capital gains at a lesser rate than ordinary income, Mr. Surrey, at page 988, states as follows:

"The advantage is so great that the courts have in some cases attempted to produce a more reasonable

> situation by refusing to consider the term 'property' as being here used by Congress in the normal all-inclusive sense in which it is used elsewhere in the Code. This judicial construction, however, in essence amounts in these situations to forgetting about the statutory definition and substituting instead a judicial concept."

Mr. Surrey, after analyzing the decision in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955), one of the principal cases relied upon in the court below by Appellant in this case, in which the court held that the dealing in corn futures by that taxpayer was not separate and apart from its manufacturing operation, and therefore such corn futures did not constitute capital assets as to that particular taxpayer, stated:

> "The Court thus resolved the dilemma by placing the congressional definition of section 1221 gently to one side and then deciding the case on its own concept of the capital gain-ordinary income division between investment and business." (p. 993).

Mr. Surrey then called attention to the decision of the Court of Appeals for the Second Circuit, *Commissioner* v. *Bagley & Sewall Co.*, 221 F.2d 944 (1955), in which the Court allowed ordinary loss sustained upon the sale of United States Government bonds required to be deposited for security of performance by a contractor having a contract with a foreign government; and to the decision of the Tax Court of the United States, *Tulane Hardwood Lumber Co.*, 24 T.C. 1146 (1955), wherein the Court allowed an ordinary loss on the sale of debentures, such debentures having been purchased by the taxpayer in need of sources of supply from a newly formed lumber company, which later failed.

In *Commissioner* v. *Bagley & Sewall Co., supra,* the Government itself had argued that the bonds there involved must be treated as capital assets unless exempted by the specific language of the section. The Court, however, held that the taxpayer intended no investment, and thus, as to the particular taxpayer in that particular factual situation, the Government bonds so held did not constitute capital assets.

In *Tulane Hardwood Lumber Co., supra,* the Court similarly held that the loss sustained in the particular circumstances "was proximately related" to the conduct of its business and that said debentures did not constitute a capital asset.

Contrasting the three cases, *Corn Products Refining Co., supra; Comm.* v. *Bagley & Sewall Co., supra,* and *Tulane Hardwood Lumber Co., supra,* Mr. Surrey then asked this question:

> "Under these decisions is there any escape from wild uncertainty? If the courts are to embark on a search for the reasons why individuals or corporations buy stocks or securities and to weigh whether an 'investment' motive is overbalanced by some other motive, many a stock or security can become an ordinary asset but no one will be able to predict when the transformation will take place." Ibid p. 999.

In the instant case, respondents were fee owners of lands. They were not engaged in the oil and gas business, nor engaged in the selling of oil and gas interests, but were partners in the Barby Cattle Company, a ranch partnership which owned and operated some 23,851 acres of land. (R. 2, par. 7).

The mineral interests here involved constituted only a portion of the entire interest, namely, surface and minerals (a fee interest).

As to respondents, the entire mineral interests owned just prior to the subject lease, constituted "property held by the taxpayer" as defined by Section 1221 and such property does not fall within any of the specific exemptions enumerated in the said section.

The reserved oil payment right, as well as the reserved one-eighth royalty interest, each, therefore, fall within the plain provisions of Section 1221, and each constituted a separate capital asset in this particular case in the hands of these particular taxpayers.

III. Did the two separate sales of undivided half interests in said production payment interest result in long-term capital gain to respondents?

The Court found in *P. G. Lake, Inc., supra* (principally relied upon by Appellant), that each of the five taxpayers involved retained an interest in the oil payment assigned, neither having parted with the whole, nor a fraction extending over the life of the property sold. On this point, it quoted from I.T. 4003 (1950-1, CB 10, 11) in part as follows (Footnote No. 5):

> "Notwithstanding the foregoing, GCM 24849 (1946-1) (Cum. Bul. 66) and I.T. 3895 (1948-1 Cum. Bul. 39) do not apply where the assigned oil payment right constitutes the entire depletable interest of the assignor in the property, or a fraction extending over the entire life of the property."

Here, taxpayers' assignment, as of November 5, 1956, was of an undivided interest of the entire reserved oil payment. Likewise, its assignment on January 3, 1957, was of the remaining undivided one-half (½) in said oil payment. Each transaction falls specifically within the exception noted by the Court in the Lake case.

In neither such sale did taxpayers retain a reversionary interest, but in each case, sold a fraction extending over the life of the oil payment. Therefore, the exception noted in the Lake decision is wholly applicable here.

IV. The ruling below neither conflicts with the decision of the Court in Comm. v. P. G. Lake, Inc., supra, nor the following decisions of the Court of Appeals for the Fifth Circuit: United States v. Foster, supra, and Floyd v. Commissioner, supra.

Appellant's entire premise under its "Reasons for Granting the Writ", beginning on page 4 of its Petition for a Writ of Certiorari, we submit, is bottomed upon erroneous conclusions. *Commissioner* v. *P. G. Lake Co., Inc., supra,* dealt with factual situations in which the respective taxpayers neither conveyed (1) the whole, nor (2) an undivided fraction of the mineral interest owned by them prior to the assignments involved. (3) Furthermore, all said mineral interests had been carved out of producing properties from which the "pay-out—could be ascertained with considerable accuracy", and this Court found that "the substance of what was assigned was the right to receive future income." Here, respondents made two sales of a complete fraction of an oil payment (an undivided one-half) in a non-producing property. Each sale thus fell within the exception set forth in I.T. 4003, *supra,* as recognized and quoted with approval in *Lake, supra.* Further, as in *Corn Products Refining Co., supra,* there is a striking parallel in the relationship of dealing in corn futures to the principal business of that company, in that here, as there, this Court found, "Lake is a corporation engaged in the business of producing oil and gas", whereas here, respondents were ranchers and not, in any wise, engaged in the oil and gas business.

In *United States* v. *Foster, supra,* the taxpayer sold only a portion of a reserved "royalty interest". In *Floyd* v. *Comm., supra,* there was no complete divestiture of the oil interest because of an agreement by the taxpayer to repurchase portions of the assigned oil payment contingent upon production.

In *Estate of Killam, supra,* the taxpayer sold only the first of two successive oil payments which he had reserved. In Floyd and Killam, as well as Lake, there was production from the property at the time of the assignment, and this production could be applied to pay-out the assigned oil payment. Further, in none of the above cases, was the Court supplied with the legislative history, above set forth, of the recognized definition of a "mineral property".

Even the theory adopted by the Court in the *Floyd* case, *supra,* was seriously questioned by Circuit Judge Wisdom in a strong dissenting opinion, in which he stated:

> "In each of the five Lake cases there was a carved out oil payment in a single property from which the oil payment was to be satisfied; and the property was assigned for the period necessary to satisfy the payment, and thereafter reverted to the assignor. Here, there is no reversion. Here, the royalty interest and the production payment are two distinct, different, separate interests. The production payment does not bear on the overriding royalty interest; the taxpayer will have that interest as long as the lease is in effect and it is payable without limit as to amount. This concept of an oil interest as a separate property distinct from other interests in the same tract has been the established view of the Treasury for many years. See U.S. Treasury Regulations, Section 1.614-1; Regulations 111, Section 29.23(m)-1(i); GCM 22106, 1941, CB 245; GCM 24094, 1944 CB 250. As I read Lake, the decision does not apply to a taxpayer's as-

signment of his entire interest in a distinct property, separate from the royalty interest and to which the assignor has no right of reversion." (p. 96).

Judge Wisdom then ended with these prophetic words:

> "I am concerned over the disruptive effects likely to be produced if Lake is applied mechanically, indiscriminately, sweepingly, whenever the owner of an interest of any sort in minerals makes any kind of conveyance by which he still retains any sort of interest in those minerals. The Commissioner seems to be saying that in every case the assignor has made a leasing or sub-leasing transaction, not the sale of a capital asset or capital investment. On the facts before us, I would hold that the taxpayer's sale of the production payment was not an anticipatory assignment of future income taxable as ordinary income." (p. 96).

Although, as stated by Appellant, the Supreme Court has made it clear that in the field of oil and gas taxation, local law characterization of interests in property are not controlling, yet it has also held that property rights are determined by local law:

Blair v. *Commissioner*, 300 U.S. 5;

Poe v. *Seaborn*, 282 U.S. 101;

Hoeper v. *Commissioner*, 284 U.S. 206.

Here, we are not concerned with the federal law as applied to the production of oil and gas income, but rather to the taxation of gains derived from the sale of a mineral property and of the application of the federal law to the gain derived therefrom.

As we have shown, this oil payment was a capital asset within the definition thereof by Congress in Section 1221. Taxpayers disposed of their entire interest in two

separate sales of said capital assets. They had held the same for more than six months, and thus the gain from the sale thereof is taxable, as Congress intended, under the capital gain provisions of the federal law.

Appellant's argument in "Reasons for Granting the Writ" of his Petition, is a continuity of his argument that the oil payment right here involved was not a capital asset, but represented simply a right to receive ordinary income, primarily under the theory of *P. G. Lake, Inc., supra.*

As we have shown in paragraphs I and II, respondents' oil payment constituted a separate mineral property and was a capital asset under Section 1221 of the Internal Revenue Code.

In actual effect, Appellant is attempting to do what the Government unsuccessfully contended for in the case of *U. S.* v. *Dresser Industries, Inc.*, 324 F.2d 56, 5 Cir. (1963); that position was succinctly stated by Circuit Judge Cameron, speaking for the Court, as follows:

> "The government contends, first, the right assigned or transferred in 1957 was not 'property' or a capital asset, but was 'nothing more' than a substitute for ordinary income to the 'selling party'; and second, that 'even assuming arguendo that a capital asset was here involved, there was no sale or exchange of that asset.'" (p. 57).
>
> "The government makes the customary broadside attack on the sale by citing the usual three cases: Corn Products Co. v. Commissioner, 1955, 350 U.S. 46, 47 AFTR 1789; Commissioner v. P. G. Lake, Inc., 1958, 356 U.S. 260, 1 AFTR 2d 1394; Commissioner v. Gillette, 1960, 364 U.S. 130, 5 AFTR 2d 1770, attempting to demonstrate that their holdings are dispositive of this case." (pp. 57-58).

Judge Cameron distinguished this case as he had in *Nelson Weaver Realty Co.* v. *Commissioner*, 1962, 5 Cir., 307 F.2d 897, 10 AFTR 2d 5569:

> "In Corn Products * * * the Tax Court * * * the Court of Appeals * * * and the Supreme Court found specifically that the taxpayer regularly dealt in corn futures as part of its everyday business operations and that they were, judicially, excluded from the definition of capital assets." (p. 58).

Judge Cameron then distinguished the Lake case by pointing out that Lake kept a reversionary interest in the property sold, the purchaser received nothing but a right to payments, said payments to terminate upon the receipt by the purchaser of $600,000.00 plus a 3% interest thereon. He stated therefore that what was sold by Lake was the right to receive money in the future whereas here, the taxpayer "is cutting off a vertical slice of its rights, rather than carving out an interest from the totality of its rights under the grant. The interest transferred was not to terminate when a certain amount was paid, as was so in Lake, and taxpayer retained no reversionary interest in the 'exclusivity' feature transferred. The tree was sold, along with the fruit, at least insofar as that branch was concerned."

Judge Cameron, continuing, distinguished the Gillette Motor Co. case by observing that the question there concerned the nature of compensation that company had received for the temporary taking by the Government (for about ten months during World War II) of its business facilities, for which the Motor Carrier Claims Commission allowed a determined sum of money for the use of Gillette's facilities at a fair rental rate. Judge Cameron pointed out further that such temporary taking by the

government of private facilities merely produced what was, in effect, rent which is usually considered ordinary income; whereas, here, the transfer involved was both permanent and final.

In further discussion of the far-reaching effect of the Lake decision, (as reflected in *United States* v. *Eidson*, 1962, 5 Cir., 310 F.2d 111), if its premise is applied in any case in which money paid represents the present value of future income to be earned should always be taxed as ordinary gains, Judge Cameron stated:

> "The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income. The value of a vending machine, as metal and plastic, is almost nil; its value arises from the fact that it will produce income."
>
> "At common law, the right to receive income from land was ownership of the land. Lord Coke said: 'If a man seized of land in fee by his deed granteth to another the profits of these lands, to have and to hold to him and his heirs, and maketh livery secundum formam chartae, the whole land itself doth pass. For what is land but the profits thereof? Co. Lit. 45.
>
> "There is, in law and fact, a vast difference between the present sale of the future right to earn income and present sale of the future right to earned income. If an asset will not in the future be useful, or capable of earning income, it is worthless in the business world.
>
> "We conclude, therefore, that the sale was not merely the present sale of the right to earned income, to be paid in the future. Taxpayer had an asset, a right, a property which would produce income. The fact that

the income which could be earned would be ordinary income is immaterial; such would be true of the sale of all income producing property. See Commissioner v. Ferrer, 1952, 2 Cir., 304 F.2d 125, 9 AFTR 2d 1651, especially the discussion beginning in the last paragraph on page 132." (p. 59).

Judge Cameron then distinguished the opinion of the Court in *Wiseman* v. *Halliburton Oil Well Cementing Co.*, 10 Cir., 1962, 301 F.2d 654, by observing that although the facts appeared similar, nevertheless it was plain in the Halliburton case that the taxpayer, prior to the transaction involved, had the right to sublicense the patent to third parties for a fee; that it gave up that right in return for a share of royalties to be received by the patent owner by licenses to be granted to third parties, and pointed out that that was not the case in Dresser. He then surmised that in the Halliburton case the taxpayer merely substituted the right to receive ordinary income from one source for the right to receive ordinary income from another, which clear distinction is evident from the facts in both cases.

Further, Circuit Judge Brown in a concurring opinion in *U. S.* v. *Dresser Industries, Inc., supra*, gave a very lucid delineation of the distinction in the nature of ordinary income from capital gain:

"Running through several of our prior opinions is the asserted concept that capital gains versus ordinary income is to be determined by the status of current earnings were the asset to have remained in the hands of the transferor. On this approach it is reasoned that if the current income would have been taxable ordinary income, then the sales price which represents the substitute for such future earnings is likewise taxable ordinary income.

"I think this is both bad economics and faulty law. A person acquires property for one of two, or both reasons. The first is to receive earnings, i.e., income. The other is to hold the property for appreciation resulting from long or short range economic conditions, inflation or the like. Normally, of course, the predominant reason is to acquire the earning capacity represented by the earnings which the property will generate.

"Hence it is that among those who trade in corporate securities on established national exchanges or over-the-counter markets, there are recognized rules of thumb by which the present value, hence market price, is determined for a given stock. The same is true in the contemporary, frequent practice of a large-scale corporate acquisition by one corporation of the stock or assets of another corporation. Value—market or sales price—is determined by capitalizing earnings. Whether the formula is the conservative one of 6 or 7 times earnings, or something less, or one considerably more speculative, what the buyer offers is his estimate of the present, discounted value of the future earnings of the assets or enterprise.

"But although this sales price is determined by future earnings, and to the seller it takes the place of what he would have received had he continued his ownership, under no stretch of the imagination is it 'ordinary income', either in the business world or in the sometimes more weird, tax world. Were this so, then every such sale for a price in excess of cost would entail this analysis and this tax consequence."

"Conceding that Congress might compel this, that the ubiquitous and voracious tax gatherer might demand it, or that courts might ultimately sustain it, the fact is that as yet none has gone so fast so far. * * * Tax law, by the hand of man, the Acts of Congress, and the doubtful clarification by Judges is complex enough without making it more so through the importation of

> bad economics. For before we realize it, economics, which knows no law of stare decisis, is infected by poor or bad law to set in train tax consequences because of what Courts have said, not because of what the actualities really are." (pp. 61-62).

We submit, therefore, that as in *U. S.* v. *Dresser Industries, Inc., supra,* respondents here clearly had "an asset, a right, a property" (the oil payment interest); that when that right was sold, a capital gain occurred.

CONCLUSION

For the reasons above set forth, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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February, 1968.